GST : an overview of
some alternatives

Background Paper

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THE GST: AN OVERVIEW OF SOME ALTERNATIVES

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INTRODUCTION

A number of experts believe that the GST has fostered the underground economy and imposes too great an administrative burden on government and business. The new government has promised to replace the GST with a tax that would generate the same revenue, would be fairer to consumers and small businesses, would not be a headache for small businesses, and would encourage federal and provincial governments to cooperate and harmonize their tax policies. In this paper, after examining the GST's impact on the underground economy and on the administrative burden, we shall discuss possible alternatives.

THE GST AND THE UNDERGROUND ECONOMY

Undisclosed income is usually estimated at between 5% and 20% of all economic activity in Canada, or between \$35 billion and \$140 billion (the exact figure is probably closer to 5% than 20%). It is likely that the GST has encouraged a number of business people to operate underground.

A tax is considered effective when it does not distort individuals' economic decisions and behaviour. The government considers it necessary to introduce an effective tax system that will no longer encourage business people to operate underground.

Some business people have decided to operate in that way because the GST imposes too great a tax burden on them and is too complicated to administer. What could be a simpler response than to stop collecting the GST from customers and thus improve one's competitive position? The Department of Finance has just completed an evaluation of the GST's

impact on the underground economy, but it has not published it. Many observers have argued that the GST has encouraged the underground economy. In his analysis of the increase in cash reserves in the hands of the public (an indicator of cash transactions) one year after the GST came into effect, Peter Spiro has shown that Statistics Canada underestimates consumer expenditures by $5.7 billion. If this analysis is correct, governments lost an estimated $2.3 billion in tax revenue in 1992.

THE COSTS OF ADMINISTERING THE GST

Several observers think that the GST imposes a heavy administrative burden on government and small businesses. In 1991-92, administering the GST cost the federal government over $486 million and required over 4,400 full-time equivalents (FTEs). Each net dollar collected as GST costs six times more in administrative costs than did the former federal sales tax (3.2 cents per dollar, as compared with 0.5 cents). To this figure must be added the private cost of administering the GST. On 17 December 1993, the Department of Finance published a report estimating this cost. According to this report, businesses whose income is less than $100,000 spend 17 cents for each dollar they collect on behalf of the federal government; those with income between $200,000 and $299,000 spend 6.6 cents for every dollar collected; and those with income of over $1 million spend 2.65 cents for every dollar collected. These estimated costs do not include the value of the time business people must spend administering the collection of money on behalf of the federal government, and are therefore lower than actual administrative costs. The Canadian Federation of Independent Business (CFIB) has estimated GST compliance costs at $5,158 per registrant, not counting one-time set-up costs. The CFIB has estimated total compliance costs to Canadian businesses at $6.642 billion in 1991 and $4,573 in 1992, with the private cost to small businesses of administering the GST at 20 cents for every dollar collected.

SOME ALTERNATIVES

From the first session of the new Parliament, the government will give the House of Commons Standing Committee on Finance a mandate to hold consultations over a 12-month period. This Committee should meet with representatives of the public and the provincial authorities in order to find a way to make taxation fairer, simpler and more harmonized.

Essentially, the alternatives to the GST are as follows: (1) introduce a business transfer tax; (2) introduce a tax on consumption (here defined as income less savings); (3) simplify the GST (eliminate some exemptions; increase the income threshold above which businesses must register) and harmonize it with the provincial sales taxes; (4) replace the GST with a more broadly-based federal retail sales tax; (5) hand the GST over to the provinces in exchange for greater latitude to impose taxes on corporations (as the Carter Commission on taxation suggested in 1966) or a reduction of some transfer payments to the provinces; and (6) drop the GST and increase individual federal income tax.

A. Business Transfer Tax

The government may replace the GST with a business transfer tax. Businesses calculate the amount of tax payable by applying a tax rate to the difference between the revenue from their sales and the cost of their purchases. Such a tax is much simpler to administer than the GST, since it does not apply to every transaction, as does the present GST. By the same token, a business transfer tax system makes it very difficult to exempt or zero-rate specific goods or services. If the government opted for this alternative, the tax base would necessarily have to be broadened, and thus the list of tax-exempt and zero-rated goods and services would have to be revised. The government could well be forced to tax prescription drugs or food, for example. Opponents will claim that this tax is hidden in the sale price. This situation would be no different from that under the former federal sales tax system.

B. Tax on Consumption

Theoretically, the simplest solution for the government, taxpayers and businesses would be to tax consumption, rather than individual expenditures. If individuals consumed only non-durable goods, consumption would be defined as the difference between their income and the change in their accumulated wealth. However, if consumption by a taxpayer purchasing durable goods is to be calculated accurately, the value of the services provided by these goods must be evaluated. The value of the services provided by the durable goods - but not their purchase price - must be included in the individual's income. For example, their imputed rents, that is, the value of the services provided by their property (an amount equivalent to the rent that would have been charged) would have to be added to the income of owner-occupants. Since estimating income from the consumption of durable goods is very complex, this type of income must be excluded; instead, the value of the goods must be taxed when they are acquired.

If consumption is to be taxed, income and savings must be evaluated using the cash basis of accounting (in which such items are recorded in the fiscal year during which the transactions take place), not the accrual basis of accounting (in which expenditures incurred and income earned in advance are accrued to the appropriate year). For example, capital gains earned but not collected (such as stocks whose value increases but which are not sold) are not included in the definition of income, while inheritances and gifts are included.

This alternative gives rise to a major problem. Individuals consume more, in comparison with their income, earlier in life rather than later; they save more in the middle of their life, while their income is lower at the end of it. This means that taxing relative consumption imposes a greater tax burden on young taxpayers, and indirectly taxes consumer debt. In order to tax consumption without imposing too great a tax burden on already indebted young taxpayers, a mechanism to defer consumption of durable goods would have to be set up. For example, the purchase of a residence might be considered a form of savings, and property-related expenditures deducted from consumption. The capital gain would be taxable when the property was sold, probably late in the taxpayer's life, when he or she would be consuming less. Since reality can be so different from theory, this alternative could, however, end up being difficult to administer.

C. A Simplified GST

The government may simplify the GST by broadening the tax base. For example, a review of the list of goods that are tax-exempt (such as financial services and already occupied residences) or zero-rated (such as prescription drugs, food and tuition fees) would allow the government to lower the tax rate and substantially simplify the administration of this tax for businesses. However, broadening the tax base could increase the number of registrants.

The government could also raise the annual income threshold above which businesses must register, for example, from $30,000 to $500,000. In this way, the government could theoretically reduce the number of returns filed. In 1992, 1.6 million registrants had annual taxable sales of $500,000 or less. Raising this threshold could lower the number of returns filed and encourage some persons not to operate underground, since small businesses would no longer administer the GST or collect tax on the goods and services they sold. However, because their goods and services would be tax-exempt, non-registrant businesses would be ineligible for the input tax credit and their clients would not be able to deduct the GST as an input tax credit. (Many businesses find it is to their advantage to be registered; they can charge the tax, and their clientele can deduct it as part of their input tax credit.) Even if the threshold were raised to $500,000, it is likely that a number of businesses would continue to register. As well, the 1992 *Auditor General's Report* showed that of the 1.7 million registrant businesses, 400,000 had taxable sales of less than $30,000; however, even though not required by law to register, they had opted to do so. According to the *Auditor General's Report*, if one-half of the eligible registrants had filed only a single annual return, processing and many related operations for some 2.4 million returns could have been eliminated. Department of Finance records indicate that 7.1 million returns were filed in 1991. Moreover, as we have just seen, unless they are forced not to register or to file only once a year, even raising the income threshold to $500,000 would quite possibly leave the number of registrants and the frequency of returns unchanged.

The government may also seek greater harmonization of the provincial sales taxes with the GST. Until now, only Quebec has agreed to harmonize its sales tax in this way, though recently the tax bases of Manitoba and New Brunswick were partially harmonized with that of

the GST. Saskatchewan has dropped its plans for harmonization. The federal government is in a very different situation from that anticipated when the *White Paper on Tax Reform* was published in 1987. On 24 April 1989, negotiations between Ottawa and the provinces on harmonizing the provincial sales taxes with the GST broke down. With the recent change in government, however, there may now be a new dynamic. Certain provinces may change their positions and agree to negotiate harmonization, something they have so far refused to do. It was also clear at the First Ministers' Conference on 21 December 1993 that an atmosphere of cooperation can be expected in the months ahead.

D. Federal Retail Sales Tax

In 1966, the Royal Commission of Inquiry on Taxation (the Carter Commission) recommended that the federal government introduce a retail sales tax jointly with the provinces (a sort of national sales tax) to replace the federal manufacturers' sales tax. The Commission considered that the provinces should assume near-complete responsibility for one major source of tax revenue; it recommended that the federal government try to reach an agreement with the provinces, under which the latter would make greater concessions in direct taxation (individual and corporate income taxes) in exchange for greater powers in indirect taxation (sales and excise taxes). The provinces would have been responsible for collecting this national sales tax. A national sales tax has the advantage of integrating sales tax systems into a single, nationwide system. Since it would have a shared tax base, a uniform federal rate, and varying provincial rates, a national sales tax would be simple to administer and involve low compliance costs. However, there is no guarantee that the federal government would be successful in negotiating the introduction of a national sales tax. If its negotiations failed, it could act independently and introduce its own retail sales tax.

A federal sales tax would be simpler to administer than the GST since it would apply only to retail sales, not to value added. If the tax base were the same, government revenue generated by a sales tax would be identical to revenue from a value-added tax. There would be far fewer registrants than the current 1.7 million. The federal government's administrative costs would be lower than under the present system; businesses' compliance costs

would also be lower, since businesses would have to calculate taxes on final sales only and would not have their present cash flow problems while awaiting their input tax credit.

Exempting producers' inputs from the tax would be more difficult, however. Under the present system, with its input tax credit, goods and services required for production are exempt from GST. If the government introduced a federal retail sales tax, all businesses would have to be made tax-exempt (which would create problems when businesses used goods and services used by both consumers and producers), or it would have to issue tax exemption certificates. Tax evasion would be easier.

E. GST Handed over to the Provinces

The federal government could hand over all jurisdiction over sales and excise taxes to the provinces, in exchange for a larger share of individual income tax and exclusive jurisdiction over corporate income tax.

Furthermore, if the federal government was unable to reach an agreement with the provinces, it could reduce or simply eliminate some transfer payments it now makes to them. In other words, in order to offset the shortfall it would incur by handing over the GST, the federal government could cut transfers of funds, equalization payments, and income tax transfers by $16 billion. The provinces could recover the shortfall by filling the taxation vacuum left by the federal government, that is, by increasing their respective retail sales taxes. It must be noted here that such a measure would create a problem for Alberta, which has no retail sales tax, and for the less prosperous provinces, such as the Maritime provinces, whose retail sales tax base is probably inadequate to offset such a reduction in transfer payments from the federal government.

At the conclusion of the First Ministers' Conference on 21 December 1993, several participants said they had discussed a redistribution of fields of taxation that would go well beyond harmonizing the provincial sales taxes with the GST. The First Ministers agreed to continue their discussions on eliminating overlap in federal and provincial fields of taxation. It is quite possible that the federal government will eventually hand the GST over to the

provinces and that the whole system of fields of taxation and transfer payments will be overhauled.

If the federal government wishes to propose this redistribution, it will likely have to include its negotiation of financial agreements with the provinces, which expire in 1994. It should also be noted that cash transfers are what allows the federal government to impose national standards, so that eliminating cash transfers would jeopardize the concept of national standards.

F. Increased Federal Individual Income Tax

The government could eliminate the GST and increase individual federal income tax. For this option to be revenue-neutral, the government would have to increase tax revenues from $60 billion to nearly $76 billion. Where progressive taxation is concerned, the government could maintain the status quo or increase the tax burden of higher-income individuals.

Some opponents of the GST will certainly argue in favour of this alternative, because it could make the tax system less regressive by increasing the tax burden of high-income individuals. They will argue that ability to pay taxes is based on income, not individual consumption: as income increases, consumption as a percentage of disposable income drops. However, according to generally accepted economic theory, consumption taxes are perceived as neutral and more effective than income taxes, since they do not distort the behaviour of economic agents. Increasing individual income tax is ineffective because it interferes with the formation of capital. Taxpayers who tend to save are taxed more heavily than those who tend to save less (that is, to consume more), since savings are taxed twice (gross income and interest income on savings are both taxed). This double tax burden reduces the net yield of savings and promotes consumption instead of savings. In order to neutralize the adverse effects on savings of increasing income tax, the government would have to introduce savings incentives such as making interest tax-deductible or making the retirement savings plan system more generous. Otherwise, unless taxpayers' behaviour changes, taxpayers who save would bear a heavier tax burden than those who consume. Consumption taxes are more effective because they are neutral and do not affect economic behaviour.

Furthermore, consumers' well-being is more affected by what they spend than by what they earn. As economist Nicholas Kaldor suggested in 1955, taxpayers should be taxed on what they take out of the social kitty (that is, what they consume), not on what they put into it (that is, what they earn). From the perspective of economics, this means that consumption taxes are fairer than income taxes. The government would have to be very careful about opting for this alternative, which takes little account of economic effectiveness or fairness.

CONCLUSION

We have provided a brief overview of some of the alternatives to the GST available to the government. For the moment, the third alternative (simplifying the GST) is clearly favoured. The new government will realize that significant savings, for both business and the government itself, can be expected if the tax base of the GST is broadened and if businesses file fewer returns. As well, given that a new government is in power and that all the provinces are having difficulty in balancing their budgets, the provinces may at last see the economic advantages of harmonizing consumption taxes.

Since the First Ministers have agreed to eliminate overlap in federal and provincial fields of taxation, it is quite possible that the fifth possibility (handing the GST over to the provinces) will become the preferred option in a few months.

One thing is certain: reforming the present tax system will not be easy. Reform must not be simply a GST by any other name. The end result of this reform could be as politically costly for the new government as were the changes to the system introduced by its predecessor.

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